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RESEARCH REPORT

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UPFRONT FUNDING OF MULTIYEAR CONTRACT
CANCELLATION LIABILITY:
NON-OPTIMUM FUNDING STRATEGY TODAY

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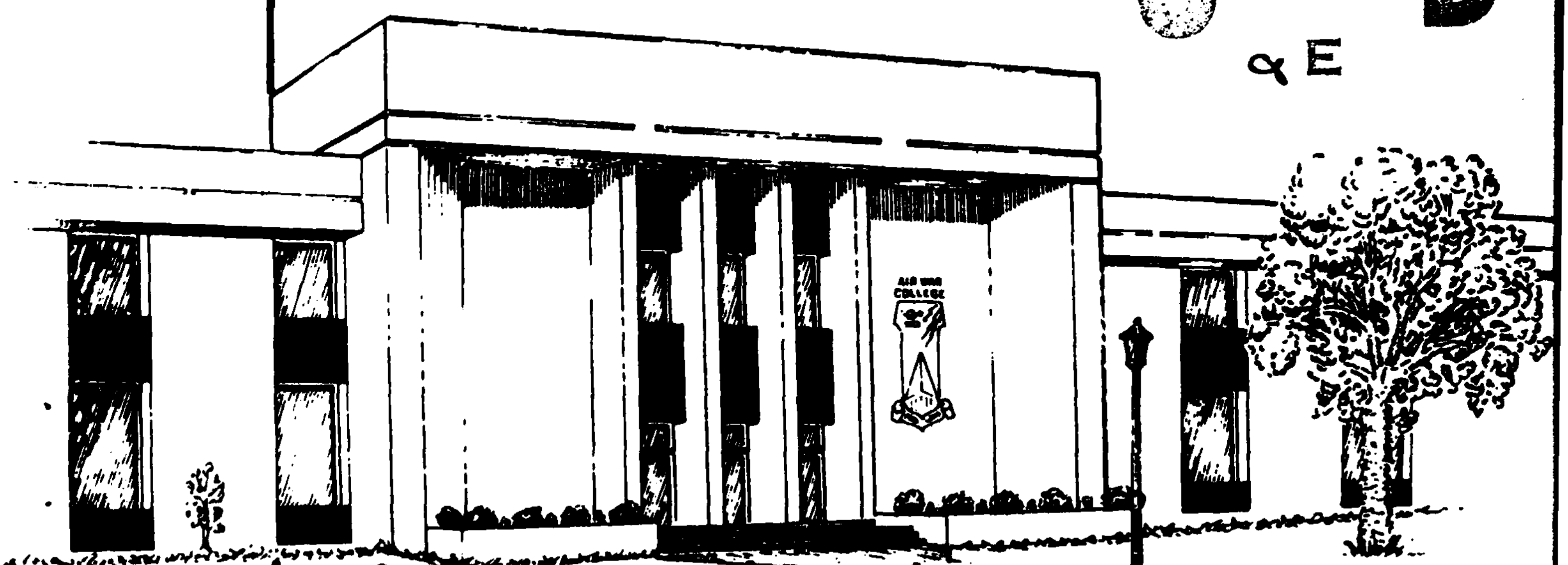

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UPFRONT FUNDING OF MULTIYEAR CONTRACT CANCELLATION LIABILITY: NON-OPTIMUM FUNDING STRATEGY TODAY

by

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A RESEARCH REPORT SUBMITTED TO THE FACULTY

IN

FULFILLMENT OF THE RESEARCH

REQUIREMENT

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AIR WAR COLLEGE RESEARCH REPORT ABSTRACT

TITLE: Upfront Funding of Multiyear Contract Cancellation Liability: Non-Optimum Funding Strategy Today

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The current funding strategy for multiyear cancellation liability is not an optimum one, especially in light of today's declining budgets for the Air Force. Air Force decision makers have not received adequate information on multiyear funding to fully appreciate the opportunities of a different funding strategy for multiyear contracts. Additionally, the financial communities within the Air Force, Office of the Secretary of Defense as well as the Congressional subcommittees have not updated their funding policies to coincide with the current decreasing budgets for defense. The end result is needless upfront funding for multiyear contracts and loss of much needed funds for ongoing defense production programs. The financial communities should review and revise their policies. Subsequently, Air Force, as well as all Defense Department services, should submit their budgets without full upfront funding of termination liability for multiyear contracts.

BIOGRAPHICAL SKETCH

Lieutenant Colonel Fredrick T. McGuire (M.B.S., University of Southern California) has been interested in multiyear programs since he was stationed at the KC-10 System Program Office at Wright-Patterson Air Force Base, Ohio in 1980. Subsequently, he has served in Research and Development positions at Headquarters Air Force. Additionally, he is qualified in both fixed- and rotary-wing aircraft and has over 250 combat missions. Colonel (selectee) McGuire is a graduate of the Air War College, class of 1988.

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CHAPTER I

INTRODUCTION

Funding methodology for multiyear programs has been continuously questioned by many since the authorization of such programs in fiscal year 1982. One specific area that has caused concern is the optimum funding strategy to cover cancellation liability. Experts within the multiyear and financial communities are divided as to the most efficient method to budget for this liability. Decision-makers (normally financial "laymen") within the force structure and program communities do not fully appreciate the concerns and subsequent impact should the funding methodology be changed. This situation has resulted in the *status quo* for cancellation liability being tied to upfront funding and needless commitment of large budget authority for multiyear programs. As a result, scarce procurement dollars are siphoned away from production use.

This situation was recognized by the Air Force's F-16 system program office (SPO). The F-16 SPO submitted a fiscal year 1984 Program Objective Memorandum (POM) without full cancellation liability being included. Subsequently, the Office of the Secretary of Defense (OSD) directed that full, upfront funding for cancellation liability be included prior to the submission of the president's budget to congress. This action had an adverse impact on the Air Force budget for fiscal year 1984 but was successfully accommodated due to the overall budget growth during this period. However, the period of growing budgets has vanished with the advent of budget deficit-reduction action by the president and congress.

It appears the time has arrived to review this mandated, upfront funding methodology. It may be in the best interest of the Air Force to submit budgets which defer full funding for cancellation liability. It may also be in OSD's interest during this financially constrained time to reevaluate their consideration of upfront funding for termination liability. And finally, congress should be afforded the opportunity to review and indicate their current desire as to requiring full funding of multiyear termination liability.

CHAPTER II

BACKGROUND

Multiyear procurement was approved with the Authorization Act for fiscal year 1982. This authorization not only approved multiyear procurement but it also provided some specific funding requirements as well as funding exceptions. Specifically, this authorization provided that full funding was not required each year to cover cancellation liability. (1:22) The particular language is as follows:

> In the event funds are not made available for the continuation of a contract made under this subsection into a subsequent fiscal year, the contract shall be cancelled or terminated, and the costs of cancellation or termination may be paid from --
>
> appropriations originally available for the performance of the contract concerned;
>
> appropriations currently available for the procurement of the type of property concerned, and not otherwise obligated; or
>
> funds appropriated for those payments. (2:14-1)

This program cancellation liability or ceiling is the amount of funding required to compensate a contractor should a contract be stopped prior to exercising the next program procurement year. Specifically, the cancellation ceiling is identified as:

> Cancellation ceiling means the maximum amount that the Government will pay the contractor which the contractor would have recovered as a part of the unit price, had the contract been completed. The amount which is actually paid to the contractor upon settlement for unrecovered costs (which can only be equal to or less than the ceiling) is referred to as the cancellation charge. (3:15)

It is important to note that cancellation results from a decision during the annual budget process to stop planned procurement for the next year. This decision to cancel would be accomplished on a multiyear contract between options of the contract and would result in not awarding the next annual option. However, the cancellation decision does not affect any of the previous options of the contract. The key point here is that the cancellation stops the multiyear contract at the end of a specific year and only affects the "complete" subsequent year(s). A thorough, yet succinct, review of the intricacies of cancellation liability is provided by Lieutenant Colonel Poleskey's article in the National Contract Management Journal. (3:15)

Cancellation liability consists primarily of two additional costs for multiyear contracts. These are non-recurring and economic order quantity (EOQ) efforts. These unique multiyear costs are incurred in all the years of the contract except the last year. Therefore, there will be no cancellation liability for the last year of a multiyear contract. Note, the real efficiency of a multiyear contract is in the advance procuring of non-recurring and EOQ effort as in contrast to annual contracts.

Cancellation liability differs from termination liability in that contract termination and thus its liability can be exercised anytime during the period of a contract.

Termination liability can include prior, current and post termination contractor costs. Termination liability is defined as:

> A procedure that may apply to any government contract, including multiyear contracts. Unlike cancellation, which is commonly effected between fiscal years and must apply to all subsequent fiscal years' quantities of items, termination may be effected at any time during the life of a contract and may apply to the total quantity or to a partial quantity of items. (4:2-2)

The current funding methodology for multiyear cancellation liability is to fully fund, upfront, all liability for next year's long lead items as well as the twelve months liability for all remaining years (except the last year) of the multiyear contract. These potential liabilities are called advanced funding. A typical example of multiyear advanced funding is exemplified with the following F-16 funding plan. (5:32)

Advanced Funding ($inM)	FY 89	FY 90	FY 91	FY 92	FY 93	TOTAL
For FY 90	453.4					453.4
For FY 91	60.4	564.6				625.0
For FY 92	41.9	92.5	402.8			537.2
For FY 93	28.9	64.3	32.8	365.8		491.8
Total	584.6	721.4	435.6	365.8	0.0	2107.4

Notice the advanced funding in FY 89 includes advance funds not only FY 90 long lead effort but also for FY 91-93 (blocked area). It is important to re-state that these are only potential charges to the government -- if the contract proceeds as planned the *actual* costs represented by these values will cease to exist, later, as hardware is delivered. It is this method of funding that drives large upfront funding requirements in a multiyear budget. The Appropriations Acts of 1983 and 1984 required the Department of Defense (DoD) to notify Congress of any unfunded liability in excess of $20 million in advance of awarding a multiyear contract. This action did *not* prohibit the use of unfunded contingent liabilities. However, the DoD Appropriations Acts of 1985, 1986 and 1987 required *all* the limits of the Government's liability be funded in order to initiate a multiyear contract. (6:1) Thus, this upfront funding began as a financial policy ojective (DoD Directive 7200.4) but has changed to a lawful funding requirement via Appropriations Acts.

There have been two attempts within the Air Force to revise this funding approach. The first attempt was with the submittal of the FY 84 POM from the Air Force to OSD. The second attempt was presented to the Air Force Board during deliberations for the FY 89 budget. Neither of these attempts were accepted, but their refusal was based on different rationale.

The first attempt was with the F-16 multiyear program, mentioned earlier. The budget submittal from the Air Force to OSD did not have all the cancellation liability funded for FY 85. OSD would not accept this policy change and the Air Force was required to fully fund all the cancellation liability in the FY 84 budget. (7) Authority for this position was DoD Directive 7200.4 containing a general policy which prohibits creating unfunded contract liabilities for multiyear contracts. (4:2) It is interesting to note this policy occurred during the period of DoD budget growth with large total obligation authority (TOA) increases, i.e. funds were less than *tight*.

The second was during FY 89 budget deliberations by the Air Force. The deliberations were a result of the Air Force having to reduce its FY 89 budget request by billions of dollars. (8) The program review committee (PRC) of the Air Force Board Structure reviewed this upfront funding policy. It was determined the Air Force should forward this policy to OSD for review as a budget reduction means for FY89. However, the Air Force financial community voiced concern during subsequent review at the Air Force Board. Their concern was these liability funds are normally used to fund reprogramming action during subsequent years. Therefore, such funds are an excellent source for reprogrammings and it would not be in the best interest of the Air Force to request OSD to review their policy. This recommendation was accepted by the Air Force Board and no further action was initiated within the Air Force.

Two points need to be mentioned with regard to this decision. First, funding that is budgeted for cancellation liability is used throughout the life of a multiyear contract. In fact, all liability funding is committed to the contract prior to exercising the last year option of the contract. Therefore, funding for cancellation liability will eventually be used and is not freely available for reprogramming -- as some would have the Air Force Board believe.

Second, continuing with the *status quo* of full funding cancellation liability is beginning to create credibility problems with congress. This is a result of not updating the DoD budget annually to the most current multiyear schedule and thus, the funding required. This area will be further discussed in the next chapter on analysis.

CHAPTER III

ANALYSIS

The DoD has been experiencing budget growths since the FY 82 authorization for multiyear contracting until FY 87. Accordingly, it has not been *too* difficult to provide larger upfront funding to satisfy full funding for cancellation liability and still continue to moderize many critical DoD weapon programs. This fact-of-life is evident with DoD Directive 7200.4 requiring full upfront funding for cancellation liability. (3:15) This situation was further exemplified with OSD's refusal to allow the Air Force in FY 84 not to budget for full cancellation liability in the F-16 program. The main concern within OSD's financial community has been from a stability aspect. Their opinion is that full funding for cancellation liability is required in order to provide credibility and to prevent chaos with multiyear funding. Early in the multiyear planning no one agreed on exactly how much or the need to commit funding on multiyear programs. Therefore, in order to instill *discipline* into the financial planning for multiyear contracts the policy of full funding for cancellation liability was decided. (9)

This same logic is present with some of the congressional subcommittee staffers for defense programs. They feel more stability will be provided with multiyear programs if cancellation liability is fully funded. Additionally, some of the staffers interviewed indicated this policy also had an additional benefit, from their perspective. They felt the DoD budgets were too large during this period of military expansion. Their position was, therefore, to require larger funding requirements, such as full funding for cancellation liability, for multiyear programs. This, in-turn, would reduce the amount of remaining funds for other defense programs. Thus, the final result would be fewer overall programs that the DoD could simultaneously procure with these increasing budgets. (10)

However, this period of budget growth for defense is clearly a thing of the past. The near-future indicates that the DoD should expect declining budgets to support efforts to control the national deficit. Acceptance of this premise should have an effect on both OSD and the congressional staffers. First, with declining DoD budgets, OSD as well as the individual military services should have a more difficult time funding this upfront cancellation requirement. DoD budgets are currently being reduced beyond the sustaining level for existing programs. The most recent budget was below the zero growth plus inflation funding level. (8) This means that defense programs can not be maintained at current schedules. Therefore, not only has the budget growth *headroom* disappeared but even more budget funding is currently disappearing for use toward defense programs. This change in the budget environment should cause OSD to revisit their cancellation liability funding policy and subsequently their 7200.4 directive.

OSD should also consider another factor during their needed directive review. Their concern for multiyear funding stability should be revisited. The infancy of multiyear contracts and the associated confusion surrounding their appropriate funding methodology has stabilized. Multiyear programs have now matured and their funding has been standardized with good insight into all funding areas. The financial communities of the individual military services, OSD, congressional staffers, as well as the contractors, have come to realize the stability of multiyear contracts. It is now time for OSD to reform their policy and change their directive accordingly.

Second, the concern of the staffers should also subside with the defense budgets entering a declining period. To begin, multiyear programs are a common occurrence today. There is stability in these programs as well as within the funding of multiyear programs. All the initial concern over multiyear funding has proven unwarranted -- no Air Force multiyear contracts have been cancelled. Additionally, staffers need not worry of too much military program growth as they did when multiyear programs first appeared. Today's military budgets are not increasing. In fact, defense budgets are declining in this deficit reduction period. Therefore, both of the staffer's concern for full funding of cancellation liability have been resolved. It is also time for them to review their policy and subsequently cease requiring DoD to fully fund for cancellation liability.

Several alternatives of the current full funding for cancellation liability exist. However, only one appears to satisfy both the acquisition and the financial communities. This approach is referred to as phased funding in Lieutenant Colonel Poleskey's article. (3:15) The approach is defined as follows:

> The phased funding approach differs from the other approaches since it employs two steps to establish fiscal-year funding levels. In one step, funding is applied each fiscal year to fund the full value of the production aircraft, as well as the termination liability of long lead time items. The resulting profile applies no funding to cover EOQ cancellation liability. At this point, funding levels for each fiscal year are examined to verify full coverage of contract termination liability in any given year.
> This check is necessary to ensure that the entire contract could be terminated in any year within the limits of available funding. In other words, the second step prevents the contract from violating the Anti-Deficiency Act (Title 31 U.S.Code, Section 665).

This type approach has benefit for DoD when funding the annual budget, especially during periods of declination. Again, the F-16 multiyear funding schedule will be used as an example.

Advanced Funding ($inM)	FY 89	FY 90	FY 91	FY 92	FY 93	TOTAL
For FY 90	453.4					453.4
For FY 91	60.4	564.6				625.0
For FY 92	41.9	92.5	402.8			537.2
For FY 93	28.9	64.3	32.8	365.8		491.8
Total	584.6	721.4	435.6	365.8	0.0	2107.4

The phased funding required in the example for FY 89 is not the $584.6M as is required with the full funding method, but is now only $453.4M for FY 90 items. This reduction is achieved by not funding the advanced items for FY 91-93 (blocked area). However, it must be pointed out these funds will eventually be required and need to be budgeted in the appropriate outyears of the contract. Notwithstanding, the Air Force could defer at least $212.6M of TOA in FY 89 alone. (5:24,32,40) This is the result of not fully funding the cancellation liability of the three Air Force multiyear programs: F-16, IIR Maverick Missile and the Defense Meteorological Satellite Program. Additional funding deferrals could be realized from other DoD multiyear programs.

Several benefits could be realized by using the phased approach and deferring upfront full funding for cancellation. First, other needed defense programs would not need to be neglected in order to fund cancellation liability. Second, by deferring funds for at least a year, an updated cost estimate would be available and thus the budget request would reflect more precise funding estimates when compared to actual cost. This would provide DoD with a corollary benefit with congress. The credibility of DoD budget request should improve with more accurate estimates as compared to actual costs. Third, multiyear candidate programs would not be penalized with large upfront funding requirements at the beginning of the multiyear period. Finally, large amounts of TOA would not needlessly be tied-up on stable multiyear programs which have already passed stringent selection criteria.

Support for a phased alternative to full funding for cancellation liability varies from strong support to ambivalence. The Air Force appears to generally support such an approach. This is particularly true in the Air Force program and acquisition communities, as exemplified with the Air Force PRC decision to seek an OSD review of their policy. The second pocket of support exists in the authorization subcommittees. Their feeling was any effort to reduce the national deficit was worthwhile, especially if it could be accomplished without program perturbation. Subcommittee staffers interviewed are willing to entertain a review of the issue should the President's Budget be submitted accordingly.

Finally, the financial communities of both OSD and the defense appropriation subcommittees are still concerned about funding discipline. However, they indicated it may be appropriate to review these funding requirements in light of decreasing budgets. (10)

CHAPTER IV

CONCLUSION

Full funding for multiyear cancellation liability is not the optimum funding strategy for existing multiyear programs. The initial uncertainty concerning multiyear stability has passed. Both the funding methodology as well as the overall growth of multiyear programs has stabilized. The financial communities, specifically OSD, must realize the concern surrounding multiyear funding is unwarranted due to standardization as well as the demonstrated stability of such programs.

The concern of defense subcommittee staffers is also unwarranted. There has not been a huge increase in multiyear programs during the defense budget growth period of FY 82-87. This stability of multiyears should be enough evidence to the most pessimistic financial staffer that runaway defense program growth is not going to happen, especially during this period of defense budget decline.

In fact, it is this decline of defense budgets that should convince all involved to reconsider the current full funding requirements. The phased approach alternative allows pursuit of ongoing multiyear programs with reduced TOA and thus more efficient funding for declining defense budgets. This should result in continuation of defense programs while accommodating a reduced budget. The real effect is deferment of such funding for a minimum of one year.

This deferment has several advantages. First, waiting at least a year to commit funds provides a better opportunity to access the overall DoD force structure. Many changes can take place in a year, especially within the research, development and procurement arena. Second, the norm within this community has been for schedules to slip. Therefore, delaying commitment of funds would allow for all programs to be better defined. Thus, program content could be definitized and any program adjustment accomplished. Finally, waiting a year to budget funds would provide a better insight of accurate costs estimates. This results from not only better program definition but also more accurate schedule representation. The culmination of these should produce a significant increase in the cost estimating accuracy for subsequent years of budget requests. Therefore, the accuracy of the estimates should be more precise along with the stable multiyear programs having standardized funding profiles. This should arrest those intangible concerns of the financial community about fully funding cancellation liability.

Subjective questions have been the only concerns raised and discussed regarding the need to fully fund cancellation liability for multiyear contracts. Seven years of historical data do not indicate any reason for such concern. In fact, just the opposite is evident. Multiyear programs have stood the test of time with respect to their stability. The stringent selection criteria have provided totally successful examples todate, over seven years of existence. Notwithstanding, the main point should be there are *legal* alternatives to fund a multiyear contract liability should this historically remote possibility of cancellation occur. (1:22)

The Authorization Act of fiscal year 1982 provided authority to treat the cancellation ceiling as a contingent liability. It also identifies steps to fund liability in the case of cancellation: 1) funds originally available from the contract concerned, 2) funds currently available for procurement of the type of property concerned, or 3) funds specifically appropriated. Unequivocally, there is an established and legal procedure to deal with such cancellation liability. Therefore, any real need to fully fund cancellation liability appears to be outdated -- multiyear funding is standardized, multiyear contracts have proven stable and established lawful steps exist to fund the remote possibility of a multiyear cancellation.

It is time for OSD as well as congress to update multiyear funding methodology in light of defense budget reductions and support national deficit reductions.

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